Electric Choice 13: *How has Michigan, and how have other states, addressed the issue of stranded costs?*

Electric Choice 20: *What data or studies should be reviewed or prepared to determine the likely effects of possible methods to calculate and recover stranded costs?*

Executive Summary

1. In the context of regulatory models, "stranded costs" refer to the decline in value of regulated assets as a result of transitioning from a regulated utility model to a deregulated model. These assets may include generating plants, power purchase agreements, and other unrecoverable assets. The recovery of stranded costs must be part of transitioning from a regulated to a deregulated market structure because investments made or costs incurred and authorized for recovery under one set of rules—i.e., regulation—could prove to be unrecoverable under a different set of rules—i.e., deregulation.

2. All states that transitioned from a regulated to a deregulated environment—including Michigan from 2001–2008—have gone through the process of determining both the amount of stranded costs and the mechanism appropriate for the recovery of those costs. The methodologies used to estimate stranded costs vary widely, as do the estimates themselves and the mechanisms used to recover them.

3. Consensus on the best way to address stranded costs, although essential to fair deregulation, has never been achieved. Any method selected will be highly controversial and invite debate about fundamental fairness, and has potential negative impact on utility customers.

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   In general, stranded cost refers to the decline in the value of an asset as a result of regulatory change. For electric utilities, the Congressional Budget Office defines stranded cost as "the decline in the value of electricity-generating assets due to the restructuring of the industry." In practice, stranded costs have included not only unrecoverable costs of generation assets, but also above-market purchased power contracts, regulatory assets, capitalized investments in social programs mandated by regulators, and employment transition costs. Stranded costs are necessary to ensure a more level playing field under deregulation and to recognize that prior investments made by utilities and authorized for recovery under a regulatory model may not have the same value under deregulated market conditions. Stranded costs are generally expected to be higher when market prices for power are low, as in today's market conditions, making deregulation costly. Major policy issues regarding stranded costs include identifying what costs should be included, defining how to calculate them, developing ways to mitigate them, and establishing a process to recover them. Another element that complicates the calculation of stranded costs is that the market value of these assets continually changes. Consequently, a figure representing recoverable costs that was derived at one point in time may turn out not to be the "final" figure or even an "accurate" one.

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Michigan partially addressed the issue of stranded costs when it implemented uncapped retail access (deregulation) from 2001–2008 as required by PA 141. The MPSC was directed to consider the reasonableness and appropriateness of various methods to determine net stranded costs, including evaluating the relationship of market value to the net book value of generation assets and purchased power contracts of utilities, evaluating net stranded costs based on the market price of power in relation to prices assumed by the MPSC in its orders, and using any other method considered appropriate. From 2001 through 2004, the MPSC opened several cases to determine the net amount of stranded costs associated with that period of deregulation. Stranded costs could be securitized under PA 141, which lowered the financing expenses associated with them, and a surcharge collected from customers was implemented allowing utilities to recover these costs from their customers. Since PA 141 was amended in 2008, utilities made additional investments required by PA 295 and other obligations to provide reliable service as regulated utilities. And even investments made prior to 2000 would likely be stranded costs given current market conditions. Thus, Michigan would have to re-open this difficult issue of stranded costs again if the 10% cap were increased or full deregulation pursued.

Different methods of determining stranded costs, changing market conditions, and regulatory rulings have resulted in a wide range of estimates among states, even within individual states that have transitioned from a regulated to a deregulated model. Consequently, the issue has proven to be highly contentious and has been aggressively litigated.

For example, despite comprehensive statutory language governing stranded costs, litigation over this issue in Texas continued for a decade since the state deregulated its electric industry and illustrates the sheer complexity and magnitude of dollars at stake. The Texas deregulation law was designed to require utilities to mitigate their stranded costs before full deregulation went into place, provide for early collection based on estimated stranded costs when deregulation began, and "true-up" stranded costs based on a final market valuation several years after deregulation began. Market conditions and regulatory decisions complicated the matter, with estimates of stranded costs ranging from $4.4 billion in 1998[1] to negative $2 billion in 2000/2001 (due primarily to high natural gas prices making higher-cost plants more economic),[2] and back up to over $6 billion several years later as part of the

[1] See Public Utility Commission of Texas, Scope of Competition in Electric Markets, January 2001.

[2] Because stranded costs were estimated to be "negative" by the PUCT, the PUCT ordered distribution utilities to provide credits (reduce the amounts owed for delivery service) to retail electricity providers. These credits were not required to be passed through to customers and many of the credits were provided to affiliated companies that could not legally reduce rates to reflect the credit. For new market entrants, the credit was intended to enhance "headroom" (difference between their costs and the price charged by the incumbent provider) and stimulate the deregulated market. The credits were later suspended by the PUCT after stranded costs were subsequently determined to be positive and, ultimately, added to the amounts that customers had to pay in the final determination of stranded costs. See Senate Committee on Business and Commerce, *Electric Utility Restructuring and Renewables: Interim Report to the 79th Texas Legislature*, December 1, 2004. Available at: http://www.senate.state.tx.us/75r/Senate/commit/c510/Downloads/EURRCh56.pdf.

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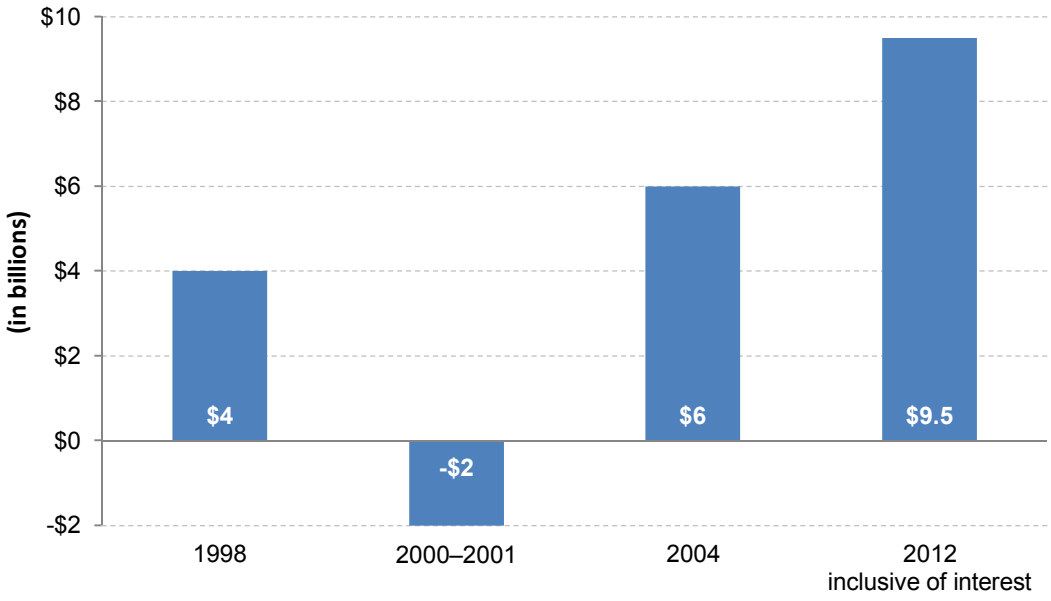
final valuation of stranded costs.[3] Including the interest to be paid by customers on stranded cost amounts before they were securitized, the total is $9.5 billion. The interest amount was significant due to the protracted litigation of the various stranded cost proceedings. The variation on stranded cost values over time in Texas are illustrated in Exhibit 1. The fluctuation in asset value driven by volatile market conditions (and, in particular, energy commodity and fuel prices) and the uncertainty and delays in regulatory and court proceedings underscore the difficulty of this issue.

EXHIBIT 1. Variation in Stranded Cost Values in Texas



SOURCE: Public Utility Commission of Texas, Scope of Competition in Electric Markets, January 2001. Available at www.puc.texas.gov; Texas Senate Committee on Business and Commerce, Electric Utility Restructuring and Renewables: Interim Report to the 79th Texas Legislature, December 1, 2004. Available at: http://www.senate.state.tx.us/75r/Senate/commit/c510/Downloads/EURRCh56.pdf. See also, securitization orders in PUCT Docket Nos. 21665, 21528, 25230, 30485, 32475, 34448, 39809, and 39931. The current value of $9.5 B includes all amounts securitized including the amount authorized in TXU Electric (now Oncor) settlement. TNMP's stranded costs, which were not securitized, are also included.

3. **The experience in both Michigan and the other states demonstrates that a consensus as to how best to address stranded costs, although essential to fair deregulation, has never been achieved. Any method selected will be highly controversial, invite debate about fundamental fairness, and has potential negative impact on customers.**

[3] The $6 billion includes $2.7 billion in additional stranded costs granted by the Texas Supreme Court in 2011 in lawsuits challenging PUCT rulings in 2004 and 2006 in the CenterPoint Energy and American Electric Power cases, respectively. The final amount would likely have been higher without a major settlement with one of the state's largest utilities (TXU Electric) that provided for zero stranded costs in return for other concessions (including permission to securitize $1.3 billion in regulatory assets).